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TREASURY FOR DONALD E SYVRUD, OASIA

E.O. 11652: N/A
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SUMMARY AND INTRODUCTION:
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1977 WAS A YEAR OF FINANCIAL IMPROVEMENT. 1978
WILL BE A YEAR OF ECONOMIC IMPROVEMENT; TO PARAPHRASE THE
CHANCELLOR, THE YEAR OF THE CAUTIOUSLY OPEN THROTTLE.
POSITIVE FACTORS INCLUDE REAL GROWTH OF GDP (IN THE RANGE
OF THREE PERCENT); CONSUMPTION (3.5 TO 4.5 PERCENT) AND
INDUSTRIAL PRODUCTION (3.5 TO 4.5 PERCENT) AFTER DECLINES
OR FLAT PERFORMANCE IN 1977. MANUFACTURING INVESTMENT

SHOULD IMPROVE ON 1977 PERFORMANCE, AND PRODUCTIVITY SHOULD INCREASE IN THE INITIAL STAGE OF THE UPTURN. PRICE PERFORMANCE WILL CONTINUE TO IMPROVE UNTIL MID-YEAR, AIDED BY A STABLE POUND, IMPROVED TERMS OF TRADE AND REASONABLE SUCCESS THUS FAR IN THE THIRD STAGE OF INCOMES POLICY. NORTH SEA OIL WILL HELP PUT THE UK INTO A CURRENT SURPLUS OF ABOUT \$2 BILLION. IT WILL ALSO ADD FISCAL BENEFITS; THIS, AIDED BY CONTINUED CASH SPENDING LIMITS, IMPROVED BUDGETARY MANAGEMENT, CONTROLLED GROWTH OF PUBLIC EXPENDITURE, HIGHER GENERAL RECEIPTS AS A RESULT OF HIGHER GROWTH AND AN ABILITY TO SELL GILTS WILL ENABLE THE CHANCELLOR TO INTRODUCE AN EXPANSIONARY BUDGET IN APRIL--FUELLED BY TAX REDUCTIONS--WITHOUT LOSING CONTROL OF THE PUBLIC SECTOR BORROWING REQUIREMENT OR MONEY SUPPLY.

THERE WILL ALSO BE NEGATIVE OR DETERIORATING ELEMENTS. IMPROVEMENT IN PRICE PERFORMANCE IS UNLIKELY TO CONTINUE IN THE SECOND HALF YEAR; IT WILL PROGRESSIVELY WORSEN GOING INTO 1979. THE OUTLOOK FOR EARNINGS (FROM THEIR CURRENTLY "RESTRAINED" LEVELS) ALSO WORSENS IN THE SECOND HALF. UNFORTUNATELY, THERE IS LITTLE LIKELIHOOD OF A MEANINGFUL REDUCTION IN UNEMPLOYMENT, THE MORE SO WITH NATIONALIZED AND GOVERNMENT CONTROLLED INDUSTRIES AS SHIPYARDS, STEEL AND AUTOS EGREGIOUSLY OVERMANNED. AS A RESULT OF HIGHER REAL GROWTH, GREATER IMPORT PENETRATION MUST BE EXPECTED. THE CURRENT STRENGTH LIMITED OFFICIAL USE

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OF THE POUND HAS ALREADY CUT INTO EXPORT COMPETITIVENESS AND, AFTER TWO YEARS OF RELATIVE AUSTERITY, WILL LEAD UK TOURISTS OVERSEAS IN RECORD NUMBERS. THEREFORE, SOME ALLOWANCE MUST BE MADE FOR A WEAKENING OF THE POUND FROM ITS CURRENT LEVELS LATER IN THE YEAR, DESPITE NORTH SEA OIL.

THERE ARE ALSO--FRANKLY--SOME UNKNOWNNS. WHILE IN CONTROL OF MONEY SUPPLY, THE GOVERNMENT HAS YET TO FIX MONEY SUPPLY OR DCE TARGETS FOR THE NEXT FISCAL YEAR. THESE MAY BE ANNOUNCED AT THE TIME OF THE BUDGET, AND CERTAINLY BY THE MAY ARTICLE VIII REVIEW WITH THE IMF.

THE GOVERNMENT IS FOLLOWING A FLEXIBLE EXCHANGE RATE POLICY WITH THE OBJECTIVE OF "AVOIDING DISRUPTIVE FLUCTUATIONS...MAINTAINING MONETARY GUIDELINES AND PRESERVING THE COMPETITIVE POSITION OF BRITISH INDUSTRY." THIS MAY BE HARD TO ACCOMPLISH, ESPECIALLY IF THE POUND CONTINUES TO BE STRONG IN FOREIGN EXCHANGE MARKETS. GREATER LIBERALIZATION OF CAPITAL MOVEMENTS WOULD HELP DAMPEN SUCH MOVEMENT. FORECASTS BY THE LONDON BUSINESS SCHOOL AND PHILLIPS AND DREW MADE BEFORE THE JANUARY RISE IN THE RATE HAD PUT THE POUND IN THE \$1.85 RANGE IN THE SECOND HALF OF 1978. WHEN THE POUND WAS ABOVE \$1.95 AND

APPROACHING \$2.00, UK OFFICIALS AND PRIVATE SECTOR ECONOMISTS BECAME EXTREMELY NERVOUS ABOUT THE COMPETITIVE POSITION OF UK TRADITIONAL INDUSTRY--AND THIS MUST SURELY REMAIN A MAJOR CONCERN THROUGHOUT THE YEAR. IN ADDITION,

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GIVEN THE \$16 BILLION INCREASE IN RESERVES IN 1977, SOME PREPAYMENT OF IMF DEBT IS A STRONG POSSIBILITY, AS WELL AS CONTINUED SELECTIVE PREPAYMENT OF NATIONALIZED INDUSTRY EXTERNAL DEBT.

THE CHANCELLOR HAS SOME OTHER CONCERNS THAT DESERVE MENTION. THE FIRST IS THE RESULT OF THE NEXT ELECTION, WHICH WE DO NOT DISCUSS ANY FURTHER BECAUSE IT IS UNLIKELY TO AFFECT MACROECONOMIC PERFORMANCE THIS YEAR. (AS DISTINCT FROM THE APRIL BUDGET, WHICH WILL IMPACT ON ECONOMIC PERFORMANCE AND MUST HAVE POLITICS IN MIND.) OF BOTH IMMEDIATE AND MEDIUM-TERM CONSEQUENCE IS THE DEGREE TO WHICH DEMAND MANAGEMENT DECISIONS THIS YEAR WILL

RESULT IN BOTTLENECKS, OVERHEATING THE ECONOMY, GREATER
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INFLATION AND BALANCE OF PAYMENTS DETERIORATION. DECISIONS ARE ALSO TO BE TAKEN ON UTILIZATION OF NORTH SEA OIL BENEFITS; HEALEY IS WELL AWARE OF THE DUTCH EXAMPLE, WHERE HE HAS PUBLICLY POINTED OUT THAT THE BULK OF THE BENEFIT WENT INTO WAGE INCREASES FAR EXCEEDING PRODUCTIVITY GAINS AND HEFTY TRANSFER PAYMENTS, WITH MUCH OF THE INCREASE IN DOMESTIC DEMAND MET BY IMPORTS RATHER THAN FROM DOMESTIC MANUFACTURING PRODUCTION. HIS CAUTION IN OPENING THE DOMESTIC THROTTLE IS UNDERSTANDABLE AND JUSTIFIED.

THE TEXT AND TABLES THAT FOLLOW ELABORATE ON SOME OF THE POINTS RAISED ABOVE. END SUMMARY

1. GDP

WITH GDP SHOWING VIRTUALLY NO CHANGE BETWEEN THE FIRST THREE QUARTERS OF 1976 AND 1977, IT IS UNLIKELY THAT THE FULL YEAR FIGURES WILL DO MUCH TO ALTER THE PICTURE. WHILE AVERAGE GROWTH OF AROUND 3 PERCENT IS PROBABLE IN 1978, THE RATE OF GROWTH FROM 1977 IVQ TO 1978 IVQ IS LIKELY TO BE SOMEWHAT MORE RAPID THAN THAT; IN PARTICULAR, THE ANTICIPATED BUDGET STIMULUS WILL HAVE ITS MAIN IMPACT DURING THE SECOND HALF OF THE YEAR. THE SAME HOLDS TRUE FOR THE ADDITIONAL EXPENDITURE ANNOUNCED IN THE OCTOBER 26, 1977 MINI-BUDGET.

2. CONSUMPTION

CONSUMER EXPENDITURE WILL BE THE MAIN FORCE BEHIND INCREASED REAL GROWTH IN GDP OF ABOUT 3 PERCENT IN 1978. REAL INCOMES WILL BE BOOSTED BY A COMBINATION OF REDUCED INCOME TAXATION, WAGE INCREASES, AND A DECELERATION IN THE RATE OF ANNUAL RETAIL PRICE INCREASE. THE ACTUAL RISE IN CONSUMER SPENDING WILL ALSO BE INFLUENCED BY THE SAVINGS RATIO, WHICH BECAUSE OF SLOWER INFLATION, AND
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PERHAPS A LEVELLING OFF IN THE RATE OF UNEMPLOYMENT, SHOULD DECLINE SOMEWHAT FROM ITS CURRENT LEVEL OF 13-14 PERCENT. WITH TRANSFER PAYMENTS SCHEDULED TO RISE AT A RATE OF ABOUT 13 PERCENT AND PRE-TAX AVERAGE EARNINGS INCREASING BY 13-16 PERCENT, REAL DISPOSABLE PERSONAL INCOMES SHOULD RISE BY 3-4 PERCENT IN 1978. (NOTE THAT A DECLINE OF LESS THAN A PERCENTAGE POINT IN THE SAVINGS RATIO CAN BRING THE RISE IN CONSUMER EXPENDITURE ABOVE

THAT OF DISPOSABLE INCOME. THE PATTERN OF THIS INCREASE WILL BE AFFECTED BY BOTH THE TIMING AND NATURE OF TAX CUTS AND THE CONCLUSION OF PAY SETTLEMENTS. AS A RESULT, CONSUMER SPENDING IS LIKELY TO RISE RATHER MORE SLOWLY IN THE FIRST HALF OF 1978 THAN IN THE SECOND, WHEN QUARTERLY INCREASES EXPRESSED AT ANNUAL RATES COULD BE IN EXCESS OF 6 PERCENT.

3. EARNINGS

WHILE THE CURRENT PAY ROUND IS NEARLY HALF OVER, ONLY 20 PERCENT OF EXPECTED WAGE SETTLEMENTS HAVE BEEN CONCLUDED. THE AVAILABLE EVIDENCE INDICATES THAT -- 10 PERCENT HAS BECOME THE MINIMUM RATHER THAN THE AVERAGE INCREASE -- "SELF-FINANCING PRODUCTIVITY DEALS" ARE FIGURING IN ABOUT 3 PERCENT OF THE SETTLEMENTS -- THE PUBLIC SECTOR WAGE SETTLEMENTS EXCLUSIVE OF THE MINERS, ARE AT THE 10 PERCENT LEVEL WHILE THE PRIVATE SECTOR DEALS ARE SOMEWHAT ABOVE THAT LEVEL. SINCE AVERAGE EARNINGS ARE A FUNCTION OF THE LEVEL AND DISTRIBUTION OF EMPLOYMENT, THE LEVEL OF OUTPUT AS WELL AS WAGES AND OVERTIME PAYMENTS, ANY FORECAST OF EARNINGS FOR THE PAY ROUND IS VERY PROBLEMATIC. HOWEVER, ASSUMING (A) THAT SLIPPAGE (I.E. WAGE DRIFT) DUE TO JOB SHIFTS, OVERTIME, RECLASSIFICATION AND SOME LOOSENESS OF PAY POLICY ADDS ABOUT 4-7 PERCENT TO EARNINGS IN THE PRIVATE SECTOR AND (B) PUBLIC SECTOR EARNINGS (ABOUT ONE-THIRD OF THE TOTAL) ARE HELD CLOSE TO 10 PER-
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CENT AS A RESULT OF THE FIRM RESOLVE OF THE GOVERNMENT NOT TO BREACH ITS OWN PAY GUIDELINE, THEN OVERALL EARNING

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ARE LIKELY TO RISE ABOUT 13-16 PERCENT DURING THE PAY
ROUND. THE PATTERN OF SETTLEMENTS INDICATES THAT ABOUT
THREE FOURTHS OF THAT INCREASE WILL OCCUR BETWEEN JANUARY
AND JULY 1978.

THE WIDE RANGE GIVEN FOR BOTH POTENTIAL RETAIL
PRICE INCREASES (8-11 PERCENT) AND AVERAGE EARNINGS (13-
16 PERCENT) IS INDICATIVE OF THE DEGREE OF UNCERTAINTY IN
THE EXISTING SITUATION. OPTIMISTS WOULD FAVOR THE LOWER
RANGE, PESSIMISTS THE HIGHER (AND SOME PRIVATE SECTOR
FORECASTERS CONSIDER AVERAGE EARNINGS WILL BE IN THE 17 -
18 PERCENT RANGE). FRANKLY, THE EMBASSY HAS DIVIDED
VIEWS ON THE SUBJECT, IN PART BECAUSE OF THE IMPOSSIBILITIES
OF GAUGING ACCURATELY (A) THE DEGREE OF WAGE DRIFT IN THE
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CURRENT PAY ROUND (IT WAS ROUGHLY 3 PERCENT IN EACH OF
THE TWO PREVIOUS ROUNDS) (B) THE TRADE UNIONS' REACTION
TO WHATEVER FORM OF INCOMES POLICY (OR LACK OF IT) IS
LIKELY FROM THE SECOND HALF OF 1978 ONWARDS, AND (C) HOW
QUICKLY THESE GET TRANSLATED INTO RETAIL PRICE INCREASES.

4. RETAIL PRICES

AFTER RISING ON AVERAGE 15.9 PERCENT IN 1977, RETAIL
PRICES WILL INCREASE CONSIDERABLY MORE SLOWLY IN 1978.
HOWEVER, THE FAVORABLE IMPACT OF AN APPRECIATING POUND,
THE MARKED DECELERATION IN WHOLESALE PRICES OF FINISHED
GOODS, AMPLE INVENTORIES AND THE FACT THAT MAJOR TAX CUTS
AND WAGE INCREASES WILL NOT ADD SIGNIFICANTLY TO AGGREGATE
DEMAND BEFORE MID YEAR ALL POINT TO AN ANNUALIZED
RATE OF PRICE INCREASE DURING THE FIRST 2 QUARTERS OF

1978 IN THE RANGE OF 5 TO 7 PERCENT. THEREAFTER THE OUT-LOOK IS ONE OF A GRADUAL REACCELERATION OF PRICE INCREASE IN THE FACE OF RISING DEMAND, AN UNCERTAIN FUTURE FOR FURTHER PAY RESTRAINT, AND PROBABLY A SOMEWHAT WEAKER EXCHANGE RATE.

AS A RESULT, MONTHLY PRICE INCREASES DURING THE SECOND HALF OF 1978 SHOULD MOVE UP FROM THE 0.5 PERCENT RANGE TO A LEVEL IN EXCESS OF 1.0 PERCENT BY YEAR END. THE AVERAGE RATE OF INFLATION FOR 1978 SHOULD THUS FALL IN THE 8-11 PERCENT RANGE WITH THE RATE OF ACCELERATION DURING THE SECOND HALF OF THE YEAR DETERMINING WHICH END OF THAT RANGE IS NEARER THE FINAL OUTCOME. BY THE FOURTH QUARTER THE ANNUALIZED RATE SHOULD HAVE RETURNED TO DOUBL DIGITS, A RATE WHICH SHOULD CONTINUE INTO 1979.

5. INDUSTRIAL PRODUCTION

INDUSTRIAL PRODUCTION IS LIKELY TO HAVE SHOWN ONLY NEGLIGIBLE GROWTH IN 1977. IT CAN BE SAFELY PREDICTED LIMITED OFFICIAL USE

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THAT THIS RECORD WILL BE BETTERED IN 1978. BY HOW MUCH WILL BE DETERMINED BY THE LEVEL OF INVENTORY ACCUMULATIO AND THE LEVEL OF IMPORT PENETRATION. THE CONSTRUCTION SECTOR WHICH ACCOUNTS FOR 14.6 PERCENT OF INDUSTRIAL PRO-DUCTION APPEARS SET FOR A DEGREE OF RECOVERY FROM A LEVEL ABOUT ONE SIXTH BELOW THE 1970 BASE YEAR. MANUFACTURING OUTPUT WHICH CONTRIBUTES FULLY 74.5 PERCENT TO INDUS-TRIAL PRODUCTION IS ALSO LIKELY TO IMPROVE AFTER THREE YEARS OF STAGNATION, LED BY CHEMICALS, TEXTILES, AND TO A LESSER EXTENT, ENGINEERING. A FURTHER 60 PERCENT RISE IN NORTH SEA OIL PRODUCTION WILL ALSO BOOST THE INDEX WHICH SHOULD PUT AN OVERALL RISE OF BETWEEN 3.5 AND 4.5 PERCENT DURING THE YEAR WITHIN REACH.

6. PRODUCTIVITY AND EMPLOYMENT

DURING THE SECOND HALF OF 1977, MANUFACTURING EMPLOYMENT SHOWED A PERCEPTIBLE RISE WHILE OUTPUT REMAINE VIRTUALLY UNCHANGED. THIS POINTS TO A FURTHER DETERIORA-TION IN PRODUCTIVITY, AS MEASURED BY OUTPUT PER MAN FROM THE 2.0 PERCENT DROP THAT OCCURRED IN THE SECOND QUARTE OF 1977. AT THE SAME TIME, THE RATE OF INCREASE IN UNEMP LOYMENT SLOWED SHARPLY DURING 1977. THE PICTURE EMERGING FROM THE FIGURES IS ONE OF A DEGREE OF LABOR HOARDING, IN PART GOVERNMENT FINANCED, PERHAPS IN ANTICIPATION OF A STRONG UPTURN IN 1978.

UNDER THESE CIRCUMSTANCES IT IS UNLIKELY THAT INDUS TRY WILL BE TAKING ON MUCH ADDITIONAL MANPOWER AS DE-MAND PICKS UP. THERE IS LIKELY TO BE A TENDENCY TO USE EXISTING LABOR MORE INTENSIVELY FOR AS LONG AS POSSIBLE, THUS BRINGING ABOUT AN IMPROVEMENT IN PRODUCTIVITY, A

DECLINE IN UNIT LABOR COSTS, AND IMPROVED PROFITABILITY.

SUCH BEHAVIOR HAS IMPORTANT IMPLICATIONS FOR THE
LEVEL OF UNEMPLOYMENT IN A SITUATION WHERE DEMOGRAPHIC
FACTORS WILL ADD NEARLY 0.2 MILLION WORKERS TO THE LABOR
FORCE. CHIEF AMONG THEM IS THE PROBABILITY THAT UNEMPLOY
MENT WILL NOT SHOW MUCH DECLINE FROM ITS CURRENT LEVEL OF
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1.43 MILLION (6.0 PERCENT) OVER 1978. IN FACT, THE JOB-
LESS TOTALS MAY INCREASE SLIGHTLY THROUGH THE SUMMER

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WHEN LARGE NUMBERS OF SCHOOL LEAVERS ARE ADDED TO THE
ROLLS. HOWEVER, IT IS ALSO PROBABLE THAT A DECLINING

TREND WILL SET IN DURING THE 3RD AND 4TH QUARTERS AS THE LEVEL OF ACTIVITY SHOULD BE SUFFICIENT TO ABSORB SOMEWHAT MORE THAN THE NET ADDITION TO THE LABOR FORCE.

7. INVESTMENT

PART OF THE EXPLANATION FOR THE RELATIVE STAGNATION IN 1977 WAS AN UNEXPECTEDLY LARGE REDUCTION IN PUBLIC SECTOR INVESTMENT WHICH HELPED TO REDUCE OVERALL GROSS FIXED CAPITAL FORMATION BY ABOUT 6 TO 7 PERCENT. WHILE HMG WILL NOT ENGAGE IN LARGE-SCALE CAPITAL SPENDING IN 1978, NEITHER WILL 1977'S FALL OF ABOUT 20 PERCENT IN LIMITED OFFICIAL USE

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GOVERNMENT CAPITAL EXPENDITURE BE REPEATED.

AS A RESULT, THE MAIN IMPETUS IN CAPITAL OUTLAYS WILL COME FROM THE PRIVATE SECTOR, WHICH ACCOUNTS FOR ABOUT 60 PERCENT OF TOTAL FIXED INVESTMENT. OVER THE FIRST THREE QUARTERS OF 1977 THERE HAS BEEN A SHARP REBOUND IN THIS SECTOR (UP 13 PERCENT) AND THIS PATTERN SEEMS SET TO CONTINUE INTO 1978 WITH A FURTHER RISE OF 10 TO 15 PERCENT IN PRIVATE SECTOR INVESTMENT LIKELY. IN ADDITION, SHARP DECLINE IN MORTGAGE INTEREST RATES HAS SET THE STAGE FOR AN UPTURN IN NEW HOUSING CONSTRUCTION. WHILE NEW NORTH SEA INVESTMENT WILL CONTINUE TO DECLINE FROM 1976-77 PEAK LEVELS, SMALL RISES IN OUTLAYS IN DISTRIBUTIVE INDUSTRIES TOGETHER WITH THE AFOREMENTIONED RISES IN MANUFACTURING AND HOUSING SHOULD HELP PRODUCE A 5 TO 6 PERCENT INCREASE IN GROSS FIXED CAPITAL FORMATION IN 1978.

INVENTORY INVESTMENT HAS SHOWN A PATTERN OF INVOLUNTARY ACCUMULATION DURING THE FIRST HALF OF 1977 WITH STOCKS RISING AT AN ANNUAL RATE OF 3.2 PERCENT OF GDP. THE SECOND HALF OF THE YEAR HAS SEEN A CORRECTION WITH ABOUT A ONE-FIFTH OF THE FIRST HALF RISE BEING WIPED OUT IN THE 3RD QUARTER, A PROCESS WHICH APPEARS TO HAVE CONTINUED IN THE FOURTH QUARTER. WITH THE INVENTORY SALES RATIO STILL ABOVE HISTORIC NORMAL LEVELS, 1978 MAY BEGIN WITH SOME FURTHER DECUMULATION BUT THEN INVENTORIES SHOULD AGAIN BEGIN TO RISE.

8. GOVERNMENT

ONE OF THE SURPRISES OF 1977 WAS THE WAY IN WHICH PUBLIC EXPENDITURE FAILED TO ACHIEVE PLANNED LEVELS. THIS WAS PARTICULARLY APPARENT IN PUBLIC SECTOR INVESTMENT WHERE THE DECLINE SEEMS LIKELY TO BE NEARLY TWICE AS LARGE AS PLANNED. THIS IS NOT THE ONLY AREA WHERE EXPENDITURE LIMITED OFFICIAL USE

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HAS BEEN UNDERSHOOTING TARGETS. SPENDING ON CURRENT GOODS AND SERVICES COVERED BY CASH LIMITS WAS ABOUT 3.5 PERCENT BELOW TARGET DURING THE FIRST HALF OF FY77/78 AS A RESULT OF THESE SHORTFALLS, FISCAL POLICY WAS TIGHTER THAN PLANNED AND THE CONTRIBUTION OF PUBLIC EXPENDITURE TO GROWTH IN 1977 WAS NEGATIVE. IN 1978/79 PUBLIC EXPENDITURE IS PLANNED TO RISE BY 2.2 PERCENT IN REAL TERMS THIS IS LESS THAN THE EXPECTED REAL GROWTH RATE OF GDP. THERE IS ALSO LIKELY TO BE AN ACTUAL INCREASE IN PUBLIC SECTOR INVESTMENT DURING THE SECOND HALF OF THE FISCAL YEAR. IN ADDITION, WE ANTICIPATE A SUBSTANTIAL CUT (SAY 2.8 BILLION POUNDS) IN PERSONAL INCOME TAXES PARTIALLY OFFSET BY A RISE (SAY 0.8 BILLION POUNDS) IN INDIRECT TAXATION IN THE SPRING BUDGET. WITH FISCAL DRAG ALREADY OFFSET BY LAST OCTOBER'S MINIBUDGET, THIS IMPLIES A NET STIMULUS OF ABOUT 2 BILLION POUNDS, OR ROUGHLY 1.5 PERCENT OF GDP. IT SHOULD BE NOTED THAT ONLY THREE QUARTERS OF THIS WILL AFFECT CALENDAR 1978.

9. PUBLIC SECTOR BORROWING - MONEY SUPPLY

THE PUBLIC SECTOR BORROWING REQUIREMENT (PSBR), AS A RESULT OF THE EXPENDITURE OVERESTIMATES AND PERHAPS SOME REVENUE UNDERESTIMATES, SHOULD REACH ABOUT 6.5 BILLION POUNDS IN THE CURRENT (1977/78) FINANCIAL YEAR, CONSIDERABLY BELOW THE BUDGET FORECAST OF 8.5 BILLION POUNDS. THE CHANCELLOR'S LETTER OF INTENT OF DECEMBER 14, 1977 TO THE IMF REAFFIRMED THE 8.6 BILLION POUND PSBR CEILING FOR 1978/79 AND WE BELIEVE THAT THE GOVERNMENT WILL STRIVE TO MAINTAIN THIS CEILING. UNDER CURRENT POLICIES, THE PSBR WOULD PROBABLY BE IN THE RANGE 6.0 TO 6.5 BILLION POUNDS FOR 1978/79. THE 2 BILLION POUND (INITIAL) TAX REDUCTION THAT IS ANTICIPATED IN APRIL SHOULD (WHEN ALLOWANCES FOR INDUCED REVENUE EFFECTS OVER THE FINANCIAL YEAR ARE MADE) RAISE THIS BY PERHAPS 1.5 BILLION POUNDS. THIS LEAVES ONLY A LITTLE ROOM, GIVEN THE HISTORY OF POOR FORECASTING OF THE PSBR, FOR THE LIMITED OFFICIAL USE

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POSSIBILITY OF A LAST-MINUTE ELECTION BUDGET IN THE FALL. IF SUCH A BUDGET WERE PRESENTED, IT COULD HAVE LITTLE

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EMPLOYMENT IMPACT IN THE CALENDAR YEAR BUT MIGHT BE
JUDGED TO ENLIVEN THE ELECTORATE ALL THE SAME.

DESPITE THE FOREIGN EXCHANGE INFLOW-FED INCREASES
IN STERLING M3 THAT HAVE BEEN RECORDED IN LATE 1977, WE
FEEL THAT THE AUTHORITIES WILL MEET OR BE FAIRLY CLOSE TO
THE UPPER END OF THEIR 9-13 PERCENT TARGET RANGE FOR THE
1977/78 FINANCIAL YEAR. NO TARGETS HAVE BEEN SET FOR
1978/79 AND IN FACT THE PROCEDURE OF SETTING TARGETS MAY
BE CHANGED. NEVERTHELESS WE FEEL THAT THE AUTHORITIES
WILL SEE AN M3 GROWTH ON THE ORDER OF 11-13 PERCENT AS
COMFORTABLY SATISFYING THE INCREASED TRANSACTIONS REQUIRE
MENTS OF THE ECONOMY. THE AUTHORITIES HAVE THE INSTRU-
MENTS NECESSARY TO ACCOMMODATE A PSBR OF 8.6 BILLION
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POUNDS IN SUCH A GROWTH TARGET.

THE SALES OF LONG-TERM GOVERNMENT SECURITIES
NECESSARY TO REACH THESE TARGETS SIMULTANEOUSLY WILL,
HOWEVER, WORK AGAINST ANY SIGNIFICANT FLATTENING OF THE
YIELD CURVE DURING THE NEXT YEAR.

10. BALANCE OF PAYMENTS

THE CURRENT ACCOUNT MOVED INTO A CLEAR SURPLUS IN 1977 AND SHOULD SEE AN EVEN LARGER SURPLUS IN 1978. HOWEVER THE CONTINUING IMPROVEMENT IN 1978 WILL BE PRIMARILY ATTRIBUTABLE TO INCREASED PRODUCTION IN NORTH SEA OIL AND MAY MASK CERTAIN WEAKNESSES IN NON-OIL SECTORS. THE VOLUME OF NON-OIL MERCHANDISE EXPORTS, IN PARTICULAR, SHOULD RISE BY ONLY 3 PERCENT WHILE THAT OF NON-OIL MERCHANDISE IMPORTS SHOULD RISE BY 7 PERCENT.

THE IMBALANCED INCREASES IN NON-OIL TRADE ARISE FROM TWO SETS OF ECONOMIC CONDITIONS. THE FIRST IS THAT THE UK ECONOMY WILL BE EXPANDING RELATIVELY RAPIDLY IN 1978 (SAY AT 3 PERCENT) WHILE THE EC EXPANDS LESS QUICKLY (SAY 2-1/2 PERCENT), A DIFFERENCE WHICH IS MAGNIFIED BY A HIGH UK PROPENSITY TO IMPORT.

THE SECOND SET ARISES FROM THE SHARP APPRECIATION OF STERLING WHICH MAY SEE THE TRADE-WEIGHTED INDEX OF STERLING'S VALUE INCREASE FROM A 1977 AVERAGE OF LESS THAN 62.5 TO OVER 64.5 (OR OVER 3 PERCENT) FOR 1978 AND PERHAPS AN AVERAGE DOLLAR VALUE OF \$1.85-\$1.90 PER POUND. WE ESTIMATE UK WHOLESALE PRICES SHOULD INCREASE ON THE ORDER OF ROUGHLY 9-1/2 PERCENT, WHICH SHOULD BE GREATER THAN THE AVERAGE INCREASE IN PRICES IN THE REST OF THE EUROPEAN INDUSTRIAL COUNTRIES, AND SHOULD BRING AN ADDITIONAL MARGINAL LOSS OF COMPETITIVENESS. THE EMBASSY ESTIMATES, FOR GIVEN DOMESTIC AND FOREIGN PRICES, THAT A ONE PERCENT RISE IN THE TRADE-WEIGHTED INDEX WILL RAISE IMPORTS LIMITED OFFICIAL USE

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AROUND 50 MILLION POUNDS AND DEPRESS EXPORTS BY A LIKE AMOUNT. LOSS OF COMPETITIVENESS BETWEEN 1977 AND 1978 ACCOUNTS FOR ROUGHLY A 400 MILLION-POUND DETERIORATION IN THE CURRENT ACCOUNT BALANCE. HIGHER LEVELS OF ECONOMIC GROWTH NATURALLY INCREASE PETROLEUM CONSUMPTION, BUT THIS IS OFFSET IN PART, WHEN CALCULATING THE BALANCE OF PAYMENTS IN STERLING, BY THE APPRECIATING POUND. WE HAVE ESTIMATED THAT OIL PRODUCTION WILL BE 62 MILLION TONS IN 1978. THIS MAY BE 10 MILLION TONS OR SO BELOW THE ESTIMATES USED IN SOME OTHER FORECASTS, BUT REFLECTS THE LATEST GOVERNMENT VIEW ON THE LIKELY RESULT THIS YEAR. (SEE LONDON 464).

THE DEGREE AND EFFECT OF THE LOSS IN INTERNATIONAL COMPETITIVENESS ARE STILL MATTERS OF SOME CONTENTION AMONG UK ECONOMIC ANALYSTS AND HAVE FORMED THE SUBSTANCE OF MANY RECENT COMMENTARIES. IN NOVEMBER, THE NATIONAL INSTITUTE FOR ECONOMIC AND SOCIAL RESEARCH (NIESR), FOR EXAMPLE, TOOK A FAR MORE SANGUINE VIEW OF BALANCE OF PAYMENTS PROSPECTS THAN THAT TAKEN HERE (A CURRENT SURPLUS OF 2.1 BILLION POUNDS) BUT ALSO INCORPORATED EROSION OF

THE NON-OIL VISIBLE TRADE SURPLUS OVER 1978. (SEE
LONDON 20703, 1977)

THE NIESR AND OECD (\$3.4 BILLION SURPLUS) FORECASTS
APPEAR HIGH TO US. OUR OWN IS CLOSER TO THE CURRENT
ACCOUNT SURPLUSES FORECAST BY THE LONDON BUSINESS SCHOOL
(1.4 BILLION POUNDS) AND PHILLIPS AND DREW (1.2 BILLION
POUNDS). WE FEEL THAT THERE ARE PLAUSIBLE DEVELOPMENTS
THAT COULD BRING THE SURPLUS TO A LEVEL LOWER THAN OUR
RANGE AS WELL AS THOSE THAT COULD BRING IT TO A HIGHER
LEVEL. NONETHELESS, THE 900-1300 MILLION POUND
RANGE WE GIVE IN THE FOLLOWING TABLE IS OUR BEST ESTIMATE
OF WHAT IS LIKELY TO HAPPEN, TAKING INTO ACCOUNT EXCHANGE
MARKET DEVELOPMENTS IN THE PAST THREE MONTHS, THEIR UN-
CERTAIN OUTLOOK IN THE FUTURE, AND THE LIKELIHOOD OF
FASTER DOMESTIC GROWTH AND THE ATTENDANT RESULTING
PROBLEMS OUTLINED IN THE TEXT.
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ACTION EUR-12

INFO OCT-01 EA-10 IO-13 ISO-00 AID-05 CIAE-00 COME-00
EB-08 FRB-03 INR-07 NSAE-00 USIA-06 XMB-02
OPIC-03 SP-02 LAB-04 SIL-01 OMB-01 NSC-05 SS-15
STR-06 CEA-01 L-03 H-01 PA-01 PRS-01 OES-07
DOE-11 SOE-02 AGRE-00 /131 W
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R 131531Z JAN 78
FM AMEMBASSY LONDON
TO SECSTATE WASHDC 2019
TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
AMEMBASSY PARIS
AMEMBASSY ROME
AMEMBASSY TOKYO
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FORECAST (MILLIONS OF POUNDS)

	1977	1978
PETRO EXPORTS	2,000	2,800
IMPORTS	-4,700	-4,500
NON-OIL EXPORTS	30,000	32,400
IMPORTS	-29,000	-32,100
INVISIBLE BALANCE	2,000	2,500
CURRENT ACCOUNT	200-300	900-1300

11. SUBJECT TO ALL OF THE USUAL CAVEATS, WE CURRENTLY EXPECT CHANGES IN THE RATE OF REAL GROWTH OF THE MAJOR ECONOMIC AGGREGATES, EMPLOYMENT AND PRICES TO BE IN THE FOLLOWING RANGE:

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PERCENT CHANGE FROM PREVIOUS YEAR

	1977	1978
GDP	0.5	2.7 - 3.3
CONSUMPTION	-1.0	3.5 - 4.0
FIXED INVESTMENT	-6.7	4.0 - 6.0
MFG. INVESTMENT	7.0	10.0 - 15.0
INVENTORY CHANGE 1)	0.4	0.0 - 0.5
GOVERNMENT EXPENDITURE	-0.5	1.5 - 2.0
VISIBLE TRADE 2)	-1.7 - -1.8	-1.2 - -1.6
INVISIBLE TRADE 2)	1.9 - 2.1	2.3 - 2.7
CURRENT ACCOUNT 2)	0.2 - 0.3	0.9 - 1.3
INDUSTRIAL PRODUCTION	0.6	3.5 - 4.5
UNEMPLOYMENT RATE 3)	6.0	5.8 - 6.0
RETAIL PRICES	15.9	8.0 - 11.0

1) AS A PERCENT OF GDP

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 jan 1994
Channel Indicators: n/a
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Disposition Case Number: n/a
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